Phoenix Asset Management Partners

2014 – Q3

Quarterly Review – 30th September 2014

Quarterly Performance:

Phoenix UK Fund (Gross)	**-4.3%**
Phoenix UK Fund (Net)	**-4.6%**
FTSE All Share (Total Return)	**-1.0%**

NAV per share:	**A Class**	**£4,164.84**	**-£199.60**
	B Class	**£4,079.52**	**-£195.51**

Introduction

There have been a lot regulatory changes in our industry recently, most of them emanating from overseas. The most significant is the AIFMD (the Alternative Investment Fund Managers Directive), a European directive that became UK regulation in 2013, that required Phoenix to apply for our authorisation again, under this new regime. That process was completed in July 2014. You can learn more about the AIFMD on the FCA (Financial Conduct Authority) website.

One of the requirements of the directive is that we have a Depository, as well as an Administrator and a Custodian. We have worked on how to implement this and have determined that the best way is to bring it all under one roof. Therefore, we will shortly be appointing State Street Global Services to do all three. They are one of the world's largest custody banks and, most importantly, do no banking or other activity likely to imperil the organisation. We have been impressed with their offering during our due diligence process; our activity will be run by their Dublin office.

Unfortunately, this change is going to require us to pester you with paperwork. I can assure you that I push back as much as I can to eliminate the unnecessary and the absurd but I can't resist the mandatory even when it's ridiculous. So if you live across the road from me in Barnes and wonder why we are asking you to verify your identity for the third time please don't knock on my door. (Call me and I will give you the Compliance Officer's address).

There is also a piece of US legislation that affects us and will impact you, it's known as FATCA (Foreign Account Tax Compliance Act). It requires us to pass information about US taxpayers to HMRC that they will share with the IRS. Again, even if you are not a US taxpayer, it's another form.

This extra regulatory burden comes at a cost and so even with the Phoenix UK Fund approaching £200m of assets the cost of running it is still hovering around 10 basis points (0.10%), a level we achieved at a tenth of this size. (This is before management fees.)

There is a benefit for investors. State Street as Depository have a responsibility to independently verify the NAV calculations and monitor the cashflows, which is why they insist on being Administrator and Custodian. It gives a much higher level of protection for investors than existed before.

I want to close by thanking Collins Stewart (now Canaccord) for providing us with an efficient and effective custody service for nearly 17 years for which they never charged and for which we have no complaints. Thank you.

Gary Channon
Phoenix Asset Management Partners 2nd October 2014

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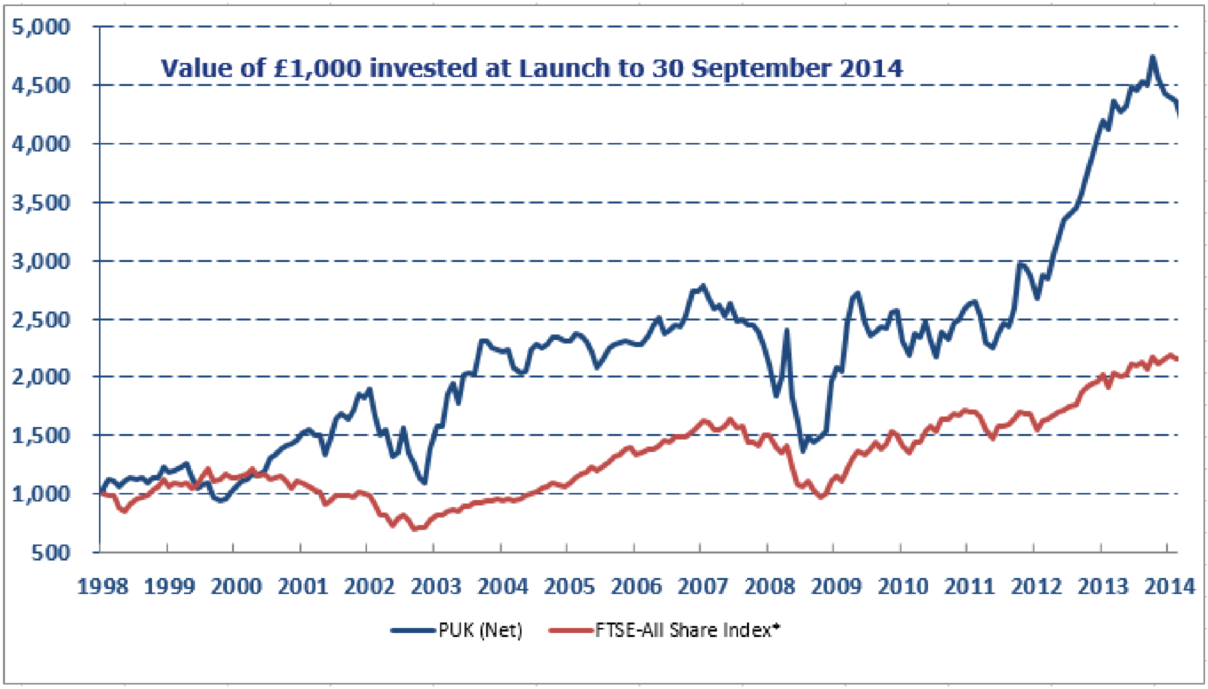
Phoenix UK Fund

Performance Table to 30th September 2014

	Investment Return (Gross)	Net Return	All Share Index	Share Price A Class
1998 (8 mths)	17.6%	14.4%	-3.3%	£1,143.71
1999	-1.3%	-4.6%	24.3%	£1,090.75
2000	24.7%	23.0%	-5.8%	£1,341.46
2001	31.7%	26.0%	-13.1%	£1,690.09
2002	-17.8%	-20.1%	-22.6%	£1,349.64
2003	51.5%	49.8%	20.9%	£2,021.24
2004	14.1%	11.2%	12.8%	£2,247.26
2005	1.4%	0.3%	22.0%	£2,254.99
2006	9.5%	8.3%	16.8%	£2,442.90
2007	3.4%	2.3%	5.3%	£2,498.40
2008	-39.5%	-40.2%	-29.9%	£1,494.31
2009	62.8%	59.7%	30.2%	£2,386.48
2010	1.1%	0.0%	14.7%	£2,386.37
2011	3.0%	1.9%	-3.2%	£2,430.74
2012	48.3%	42.2%	12.5%	£3,456.27
2013	40.5%	31.3%	20.9%	£4,539.47
2014	-6.8%	-8.3%	0.6%	£4,164.84
Cumulative	517.9%	316.5%	115.6%	
Annualised Returns	*11.7%*	*9.1%*	*4.8%*	

Phoenix UK Fund NAV Return to 30th September 2014



The Quarter

The Fund was down 4.3% in the third quarter whilst the market fell 1.0%. For 2014 year-to-date that leaves the return at -6.8% versus +0.6% for the FTSE All Share, an underperformance of 7.4%.

The damage is being done by our recent (past 3 years) retail holdings Tesco -34.5% and Carpetright -26.0%. This has in part been counterbalanced by our largest and recently added to holding of Barratt Developments rising 6.0% in the quarter, (as it left the FTSE 100 again).

It is mildly ironic that these days the volatility in the portfolio is coming from Food Retail and we get stabilising calm from Housebuilding and Banking.

Tesco

There have been dramatic developments at Tesco this quarter; a change of CEO, profit warnings, an accounting scandal and a 35% fall in the share price. Taking that all into account, we determined that Tesco had become a much better investment and doubled our holding at the end of the quarter. Why we did that and how we think about Tesco follows.

The framework we use for thinking about companies in Tesco's situation is to consider their value as being made up of two parts, let's call them A and B. Part A is the value of the turnaround/transition period and Part B is the value of the stabilised business that follows. Our investment in Tesco is primarily based upon our expectation that there is a stable state that Tesco can get to.

In these situations it is often Part A that gets worse and as it gets worse the share price falls further, much further than it should, and for those who focus on the value of Part B, great opportunities emerge. As we scale our investments based upon how good they are, our biggest and ultimately most valuable investments start off very badly. Our most successful investments, namely Barratt, Reuters, Sports Direct, Games Workshop, Diageo, ITV and Morrisons, have all taken that form.

This turnaround period for Tesco has developed in a more negative way than we expected at the time of our first investment at 399p in 2011. Yet it is not a surprise that this could happen, it often does in these situations which are hard to predict. Our investment has always depended upon what we believe Part B looks like when you get through the turnaround.

The opportunity exists because a run of bad news causes too much focus on the short term, Part A, and a disconnection between perception and reality.

Perception vs. Reality

Lost Customers

Most commentators and many analysts have said that Tesco's customers are leaving it "in droves" and this fits the prevailing perception. However, despite pulling out of a number of areas in electrical goods and the demise of physical media, Tesco's sales in the UK have not declined. Its pure grocery sales have risen continually. The UK population has not deserted Tesco.

Tesco's market share has fallen as the market has grown quicker but even this is overstated. Tesco's share of grocery spend has fallen from a peak of 31% to 29% (Kantar Worldwide). That peak was reached in 2006 with a jump of 1% following the demise of Kwik-Save and as Morrisons struggled to integrate Safeway. At that point Tesco was overtrading. In other words it had customers it probably didn't deserve. As Morrisons fixed Safeway and Kwik-Save, once the leading discounter, was replaced by Aldi and Lidl, then it was reasonable to expect the overtrading to reverse. Unfortunately, Tesco used that extra spurt of growth to widen margins, squeeze more profit out of their staff and stores and were distracted with their overseas expansion. Their competitors got their act together and Tesco's hubris was punished. However, that "punishment" so far is only about 1% to 1.5% of market share loss.

The vast majority of shoppers have not changed their habits or where they shop. We do a lot of mystery shopping of all the supermarkets in geographic clusters and the usual answer given for someone being in a particular store is proximity, i.e. it's the closest to where they live or work. This is the same motivation found by the competition authorities in their investigations in 2000 and 2008. This general demographic inertia and the UK's restrictive planning regime is what gives Tesco the time to address its deficiencies and stabilise its customer base.

Discounters

Much is made of the rise of the discounters Aldi and Lidl. As a group, discounters actually have a smaller share of the market than they did 10 or 20 years ago. Aldi and Lidl have been big beneficiaries of the demise of Kwik-Save, Netto and Somerfield. However, there is an additional phenomenon at work; it has become acceptable for the middle classes to be seen in an Aldi or Lidl, (though not in an Iceland). In Aldi we actually have middle class shoppers approaching our researchers wanting to have it on the record that they are happy and converted customers. How far this phenomenon will run we don't know but one important observation we have made is that in all the postcodes where an Aldi or Lidl exist they haven't achieved better than fourth place behind the mainstream supermarkets, even where they've been trading there for 20 years. We believe this suggests they have a natural limit in a given territory. With the current momentum, and the amount of areas where they have yet to roll out, we expect them to double their sales in the next five years.

Internet

The fastest growing part of the grocery market is online which has now reached 6% of the market. Tesco launched its online offering 14 years ago and has a dominant share of c.45% (Phoenix, ONS). That may slip as competitors like Morrisons build their new online offerings but still, in the area most likely to change shopping habits, Tesco starts with a strong position. The fastest growing part of their service is "click and collect" where having 3,400 UK stores give them a clear advantage.

By our estimation, the headwind from discounters will be offset by the growth in online and convenience stores where Tesco are strong.

Capital Structure and Returns

Our interest in investing in Tesco started when they said they would pay attention to the returns on their capital back in 2010. Before that, high returns in the UK business were being diverted for low returns elsewhere. Since the announcement Tesco's actions have been consistent with that goal. Firstly, they have stopped all those activities that generated negative returns, i.e. Japan, USA and China. In Turkey they have been trying to exit but in the meantime have got the business to profitability and stopped pouring capital into it. That leaves 8 markets (plus the UK) where they are either no.1 or no.2. The three in Asia earn high returns and have continued to receive expansion capital. The five in Europe are earning sub-par returns and their capital allocation has been constrained.

At the heart of Tesco is a very high return business because it turns its stock very quickly, collects cash on sale and pays its suppliers sometime after. It requires no capital to operate or grow, it has what we call "negative working capital". However, it has been built with an enormous freehold property portfolio (in the books at £20bn but with a higher market value) and this has made it a more capital intensive business than it needs to be. We aren't expecting any dramatic disposal but we think that the business will use a lot less capital for growth and that some of the over capitalisation will be gradually released. The impact of this will be to raise the returns on shareholders capital.

Valuation

We can use our two part model to think about the valuation. What is the present value of cash that Tesco will generate during the transition and turnaround period, Part A? Let's call it zero. That might seem extreme when even the recently lowered expectations have them making about £1.5bn a year of net profit. But it makes the thinking clearer, allows for things to get worse and also reflects that cash generation is likely to be lower than profits while they upgrade their UK stores.

All we need to do now is to value what the stabilised business will look like and to estimate when that will happen. Let's say it happens in four years' time, we think that's a reasonable estimate, and let's also say that the business shrinks a bit during the transition and once it is stabilised it doesn't grow again except by inflation, admittedly harsh. For the current share price (186p) to be right then the operating margin in the UK business would need to be stuck at 2% forever. This is around the level of Tesco's structural cost advantage over Sainsbury which means Sainsbury would be losing money and most of Tesco's other competitors would also be running at uneconomic levels. We think this is unsustainable and therefore an unlikely point of equilibrium.

A more realistic expectation for margins is that they settle at two thirds of where they were before, i.e. at 4% versus 6.2%. A conservative estimate considering the 6.7% they are earning in their Asian business. For the current share price to be correct at these margins it implies that it will take 9 years of zero cash generation before stability is reached. Any reasonable study of the oscillations of fortunes in the past few decades of grocery retailing will show that to be too extreme.

In a scenario where it takes four years to correct and margins settle at 4% then Tesco is worth £3.21. This is with zero growth anywhere forever and no cash generated in the turnaround.

These models demonstrate how little downside there is in the investment but they don't accurately reflect the potential. Our central model, which allows for some organic growth, gives some value to Tesco Bank, and assumes some modest cash generation in the turnaround, puts the value in the £5.50 to £6.00 range. Our modelling never gives any benefit to gearing, we assume all debt and pension deficits are settled at the outset. We are also not assuming any return to greatness and yet we believe it to be a reasonable possibility with Tesco once it regains its confidence.

Conclusion

The value of an investment is entirely based upon what happens in the future. The present and past are only useful if they tell us something about the future. The latest accounting scandal at Tesco tells us a lot about the past; it suggests the current has been worse but what it mainly tells us about the future is actually more positive than negative. In our experience, companies stung by this type of experience go to great lengths to avoid a repeat. Therefore, we believe the probability of future attempts to manipulate accounting have actually declined. In terms of integrity, we expect those found to have lacked it will not be part of the future. We have a high regard for Dave Lewis, the new CEO, from watching him at Unilever (still a holding) and we believe he will hold Tesco to a high standard.

The plight of Tesco viewed from a Bloomberg screen or through the newspapers is much scarier than the reality on the ground, in the shops. What needs to be done is not rocket science, it's easy to observe in Tesco's and their competitor stores but it takes time, patience and perseverance to execute. We see evidence of some of it already happening in stores that have had investment. Dave Lewis says it's about taking Tesco back to the basics on which it was built. In Maurice Corina's 1971 biography of Tesco founder Jack Cohen he said this:

Ever since we opened our first store, at the height of the Depression in 1929, we have believed in and vigorously operated a cut price policy. It is based on the simple concept that there is a greater return for capital invested in quick turnover, large-volume sales at a small margin of profit per unit, than in slow-moving, small volume sales at a large margin of profit per unit.

*The success of this policy depends upon maximum efficiency down the line from top management, buying, warehousing, distribution to the ultimate retailing unit. Overheads are kept to an absolute minimum commensurate with providing the public with quality and service.**

It's as true today as it was then.

There will probably be more bad news to come and things will get worse before they get better but ultimately we expect Tesco to get their house in order. The current share price discounts so much bad news that it's hard to see how the long term investor will suffer a loss of capital. If our estimations of the future are broadly correct then we expect to have a very satisfactory outcome from the investment.

**Pile it High Sell it Cheap, The Authorised Biography of Sir Jack Cohen, Founder of Tesco by Maurice Corina (1971)*

Activity

We added 5% to our holding in Tesco which takes its current weight to 10.4%. If Tesco rose to our average cost price of £2.60 then it would be a 13.9% weight. However, because of the way we measure and set our limits this represents the full use of our 15% cost price limit. It's down to the methodology, which we will go through at the AGM. Suffice to say we have maximised our investment and the only time we will buy more Tesco for the Fund will be when investing new subscriptions.

Although Carpetright revealed that sales have finally picked up the shares were very weak due to a large and clumsily handled disposal by the interests of Lord Harris. This sale was due to factors external to Carpetright and so we took advantage of the depressed placing price to add 4% to our holding which now has a weight of 7.7% following the mark down.

Cash has therefore declined to just 0.8%.

Intrinsic Value

Those investments have boosted our estimate of the intrinsic value of the Fund by 10.5% to £8,912 which when combined with the decline in the NAV to £4,165 means that the upside is now 114%, a £1 for 47p.

Outlook

For those who've known us for a long time this probably feels like familiar territory. The performance dragged down by a flurry of current activity. The new investments we commend to you with tales of great opportunity are the same ones that everywhere else are headlining with atrocious news, scathing opinions and price collapses. These types of situations create great opportunities but they are not easy to take. We feel like Jack Nicholson's character in As Good As It Gets who is told *"The best thing you have going for you is your willingness to humiliate yourself."* We don't set out to humiliate ourselves but we know it goes with the territory. Our approach is to focus on the facts, adjust our expectations and judgements as the facts change and then act rationally based upon those judgements. On balance in the past 16.5 years that has worked for us. We've looked like idiots many times but ultimately we've turned out to be idiots only occasionally.

What is different this time is that, in the past 6 years, we have become much better at holding on to what is really working and we have slowed the rate at which we get into new things. So, currently, more than half of the portfolio is made up of our credit crunch investments (Barratt, Lloyds, Bellway and Travis Perkins) where the businesses are performing well and we have high expectations for their long term potential. Barratt we believe is now entering the "good to great" phase. If we get this right then our long term returns should be higher and our drawdowns should be smaller.

Although the NAV has declined so far this year, the intrinsic value has risen 24% and we know from the past that it is our estimate of IV that is the best guide to where we are going.

Current Portfolio

	Date of First Purchase	Current Weight	Av. Net Cost Incl. Sales (£)	Total Dividend Income per share	Curr. Price (£)	Change in Quarter	Total Return (incl. div) vs Av Net Cost
Barratt Developments	Nov 07	25.0%	1.10	0.05	3.96	6.0%	264%
Lloyds Banking Gp	Sep 08	12.0%	0.89	0.01	0.77	3.5%	-13%
Tesco	Jan 11	10.4%	2.60	0.09	1.86	-34.5%	-25%
Bellway	Oct 12	8.9%	13.11	0.41	15.67	0.1%	23%
Carpetright	Dec 13	7.7%	4.84	0	3.70	-26.0%	-24%
GlaxoSmithKline	Apr 09	6.7%	15.17	1.29	14.13	-8.4%	2%
Travis Perkins	Aug 11	4.8%	11.37	0.54	16.64	1.6%	51%
Randall & Quilter	May 13	3.5%	1.27	1.08	1.38	-8.0%	94%
Bwin.party	Jun 06	3.1%	1.67	0.05	0.91	-3.5%	-43%
Vesuvius	Dec 12	3.1%	3.76	0.19	4.52	-0.4%	25%
Others <3% (8)		14.0 %					
Cash		0.8%					

Liquidity

% of Fund sellable in:	1 Month	2 Months	3 Months
All Investors	92%	95%	96%
Excluding Directors	100%	100%	100%

The liquidity has only marginally changed during the quarter.

Phoenix Insider Holdings

Below is a table of the number of units held by all directors and employees of Phoenix Asset Management Partners Ltd.

	Date	Total Equiv A	Units Value
Insiders' Holding	30/06/14	4,088	£17.8m
	30/09/14	4,090	£17.0m

Current Valuation Table

	Market Cap £m	Net Cash /(Debt)	Enterprise Value	Historic Operating Profit	Hist. PE	Div Yield
Barratt Developments	£3.9bn	£73.1m	£3.8bn	£410m	12.5	1.8%
Lloyds Banking Gp	£55.1bn	(£16.6bn)	£71.7bn	£6.2bn	0.0	n/a
Tesco	£15.1bn	(£6.6bn)	£21.7bn	£2.2bn	7.8	6.8%
Bellway	£1.9bn	(£5.8m)	£1.9bn	£151m	13.2	2.6%
Carpetright	£251m	(£11.1)	£261m	£7.0m	0.0	n/a
GlaxoSmithKline	£68.6bn	(£13.7bn)	£82.3bn	£7.0bn	14.3	6.3%
Travis Perkins	£4.1bn	(£348m)	£4.4bn	£330m	14.2	2.2%
Randall & Quilter	£98m	£29.3m	£68.7m	£10.2m	19.4	5.0%
Bwin.party	£737m	£64m	£673m	£43m	0.0	4.1%
Vesuvius	£1.2bn	(£256m)	£1.5bn	£140m	11.2	3.8%

Weighted Averages

Portfolio	**£17.4bn**		**10.5**	**3.2%**
FT-All Share	**£3.4bn**		**16.2**	**4.5%**
FTSE 100	**£17.9bn**		**16.5**	**4.8%**

Company News - Existing Holdings

Barratt Developments – Current Weighting 25%

At the end of July the Government launched another major consultation that may result in a planning regime that is more conducive to residential development. The consultation finished at the end of September.

In September Barratt released final results for a year that was described by outgoing Chairman Bob Lawson, as being "outstanding". Group revenue rose 21% to £3.2bn as total completions were up 8.6% to 14,838 and the average private selling price increased by 12.9% to £242k. The operating margin rose strongly from 9.7% to 13% as the Company continues to benefit from building on higher margin land, acquired since the downturn. Return on capital employed rose from 11.5% to 19.5%, meaning the business reached its internal target of an 18% return on capital two years early. Year-end net cash was £73.1m, the first time in eight years that the year-end cash position has been positive. The Company announced that they would return £400m of surplus cash in addition to the dividend over the next few years.

Since re-entering the land market in 2009, Barratt have spent £3.8bn on land using a 20% gross margin and 25% ROCE hurdle rate. Consequently, the proportion of old lower margin land is shrinking fast; in 2014 65% of all completions were built on new land (2013: 49%). This ongoing conversion of the land bank will drive margins higher (assuming flat sales prices) for the next several years. Barratt bought £1.2bn of land in the year and also reported good progress on developing its strategic land portfolio. Until recently, the strategic land-bank has lagged the sector although they now have c. 69,200 plots up from c. 59,800 last year. 10% of 2014 completions were on strategically sourced land, up from seven per cent last year; Mark Clare said that within a couple of years the number will get to 20%. It is estimated by Barratt that strategic land carries a 3% margin advantage over "oven ready" land.

A very pleasing feature of the results and our subsequent meeting with management was that there is currently a very clear focus on continuing operational excellence and incremental improvement. A short list of highlights include:

- The Barratt Graduate recruitment scheme is ranked # 1 in the country by a leading careers website. The scheme receives outstanding feedback from the participants. Read more about it for yourself at www.thejobcrowd.com/top-companies-to-work-for
- Extensive use of the "Net Promoter Score" (NPS) assessment system for measuring the performance of the business
- Creation of an undergraduate degree to train future assistant site managers at Sheffield Hallam University; the only such degree course in the country
- Barratt won more NHBC "Pride in the Job Awards" than any other house builder for the tenth year in a row

FD David Thomas updated his guidance for 2015; they expect 15,000 completions excluding joint ventures and that operating profits will continue to rise. Average net debt is expected to be £300m for the year. Furthermore, the Company announced that it has set a new group ROCE target of 25% by FY17.

Mark Clare said that the very early signs of the autumn selling season were positive albeit the housing market has reverted to a more seasonal pattern.

The share price increased 6% in the quarter.

Lloyds Banking Group – Current Weighting 12%

Lloyds reported a strong improvement in underlying performance in their Interim results with lending growth in key customer segments and deposit growth in their relationship brands. This generated underlying income of £9.3bn with net interest income up 12% driven by margin improvement to 2.4% (with the full year expected to be 2.45%) despite other income down 8% given disposals and a challenging environment. Underlying costs were also down 2% and the impairment charge down 58% (with the asset quality ratio improving a further 39bps from 0.69% to 0.30%) to give an underlying profit of £3.8bn. Disappointingly, with further legacy charges of £1.1bn and other charges for TSB and volatile items this resulted in statutory PBT of £0.86bn and a tangible net asset value per share of 49.4p.

As mentioned in the previous quarterlies, Lloyds have now reached two milestones: i) the Government shareholding reduced to 24.9% and ii) the successful IPO for TSB with 38.5% sold generating £455m gross proceeds. They continue to successfully run-down their non-core portfolio, which is now expected to be less than £20bn by end of 2014. Their capital position has strengthened further with a 'fully loaded CET1 ratio' of 11.1%; a total capital ratio of 19.7% and a comfortable Basel III leverage ratio of 4.5%. They will apply to the PRA (Prudential Regulatory Authority) this half to restart dividend payments.

The regulatory environment continues to evolve with: i) the PRA and European Banking Authority (EBA) detailing their extensive stress tests, with whom Lloyds are currently working with to agree their position; ii) the Bank of England, as part of their investigation on capital frameworks for banks, is now focusing on leverage, which Lloyds is comfortable with at 4.5%; iii) the FCA have announced a number of reviews across the retail financial services sector, including reviewing certain elements of customer personal accounts and so on and although the nature of the conduct regime has changed significantly in recent years, Lloyds are confident their customer focus, low risk business model puts them in a good position; iv) and finally in July, the Competition and Markets Authority announced it was consulting on whether to investigate the markets for personal current accounts and SME banking.

Antonio Horta-Osorio concluded*, "It has been a successful half year for the group. With our initial three-year strategic plan now substantially complete, we are progressing our plans for how we will take the Group forward in 2015 and beyond,* *and take advantage of the new growth phase of the UK economy. We intend to share these plans in the Autumn".* Lloyds continues to be well placed to support and benefit from the strengthening UK economy to deliver strong and sustainable returns.

The share price increased 3.5% in the period.

Tesco – Current Weighting 10.4%

In July, Tesco announced that Alan Stewart would take over as Chief Financial Officer after he had served his notice with his previous employer, M&S, where he was also CFO. Alan Stewart started his career in investment banking with HSBC and has previously been CFO at Thomas Cook and WH Smith. He is also due to start a role as a non-executive director of Diageo.

Shortly after announcing the replacement of the CFO in July, Tesco issued a trading update explaining that the CEO, Philip Clarke, would be stepping down and that trading had been more challenging than expected. The statement explained that the overall market is weaker in the UK and that the investments that they were making to improve the customer offering and build long term loyalty would result in both the sales and profits being lower than expected. The replacement for Philip Clarke is Dave Lewis who has worked for Unilever in various roles since 1987 when he joined as a graduate. Dave Lewis has been responsible for a number of turnarounds at Unilever and his final role was as global head of Personal Care.

At the end of August, Tesco issued another trading update which contained details of a further downgrade to profit expectations. Expected trading profit is to be in the range of £2.4-2.5bn for the financial year 2014/2015 and that trading profit in the first half of this year would be £1.1bn. In reaction to the prevailing conditions, the board deemed it appropriate to reduce the dividend by 75% and reduce capital expenditure by £600m relative to last year. We were also told that the new CEO would be joining a month earlier than expected.

On Monday 22nd of September, Tesco then issued a further trading update to notify shareholders again of a downgrade to profit guidance. This time, it was discovered that there was a problem with the way they were accounting for commercial income from suppliers and the timing of some costs. The net effect of this was deemed to be a downgrade of £250m to the first half trading profit. The following day, Tesco notified shareholders that the incoming CFO, Alan Stewart would be joining immediately, rather than serving his full notice with his previous employer.

The share price was down 34.5% in the quarter.

Bellway – Current Weighting 8.9%

In July, Bellway issued a pre-close trading update for the year to July 31st ahead of the results announcement in October. The group performed very strongly with completions up 21% to 6,851. All regions performed well, including London, which has been the focus of recent investment. The average selling price rose to £213k (from £193k), which together has generated housing revenue of £1.46bn. The net cash position was £5m (2013 – debt of £5.8m). The forward sales position was very strongly ahead, up 36% to £924m. Customer demand has been robust throughout the year as the housing market has continued to improve, largely due to the Government Help-to-Buy scheme. Bellway have continued to buy land in what is a very attractive market, spending £460m in the period. CEO Ted Ayres said that "*this record forward sales position, together with continuing consumer demand for new homes, allows the Group to continue its strategy of sustainable volume growth at attractive rates of return, thereby resulting in further enhancements to shareholder value*".

The share price increased 0.1% in the quarter.

Carpetright – Current Weighting 7.7%

The Company issued a quarterly IMS in July. Like- for-like sales increased by 6.1% in the UK at the expense of 2.6% gross margin; the gross margin decline is expected to be between 50 – 100 basis points for the full year. The improvement in sales accelerated towards the end of the reporting period. Sales in Europe declined by 3.9% in local currency with an increase in gross margin in-line with previous guidance of 2.5% for the full year. The European business has been returned to profit.

Wilf Walsh joined as CEO in July and Lord Harris became non-executive Chairman.

During the Quarter, both Lord Harris and Martin Harris sold shares in the Company.

The share price fell 26% in the quarter.

GlaxoSmithKline – Current Weighting 6.7%

In July, GlaxoSmithKline reported in their interim results that the core operations had had a tough first half with Sales decreasing at 3% and operating profit down 7% at constant exchange rates. Pharmaceutical and vaccines sales were down 4% due to continued competition in the US market and generic competition for Lovaza. Emerging markets performed strongly on a sales basis again (+11%) but this was offset by declines in Japan (-7%) and the US (-10%). Pharma and vaccine sales in Europe were flat year-on-year.

In pharma, the key respiratory business is currently going through a transition period away from the single blockbuster Advair drug to a more diversified portfolio including Breo, Anoro and Incruse amongst others. This has negatively impacted sales in the short term as the new products ramp up.

HIV sales were up 13% relative to last year due to the strong uptake of the recent integrase inhibitor, Tivicay. Vaccines grew particularly strongly in emerging markets (+26%) driven by the phasing of tenders.

Consumer healthcare sales declined by 5% as the supply problems highlighted in the first quarter results persisted. Management guided full year sales for this division to be flat year-on-year.

The large strategic transaction with Novartis announced earlier this year is progressing as planned and the company has also now started the process to divest their established products portfolio which has sales of c. £1bn currently.

Core earnings for the full year are expected to be broadly similar to last year on a constant currency basis.

On the 19th September; following an investigation initiated by China's ministry of public security in June 2013, GSK was deemed to have offered money or property to non-government personnel in order to obtain commercial gains. As a result of the court's verdict, GSK have paid a fine of £297m to the Chinese government. This was funded through existing cash resources.

GSK CEO Andrew Witty said "reaching a conclusion in the investigation of our Chinese business is important, but this has been a deeply disappointing matter for GSK. We have and will continue to learn from this. GSK has been in China for close to one hundred years and we remain fully committed to the country and its people. We will continue to expand access to innovative medicines and vaccines to improve their health…"

The share price was down 8% in the quarter.

Travis Perkins – Current Weighting 4.8%

The Company issued interim results in July. CEO John Carter said that, "a *combination of improving market conditions, increasing customer confidence and the successful introduction of a number of self-help initiatives has driven a strong first half performance*". Sales rose 11.5% to £2.7bn and profit before tax rose 19.4% to £163m. The group benefitted substantially from the broad improvement in the construction market over the last six months with a particularly strong contribution from the house building and residential sector. We had been expecting a cyclical uplift to trading for a while as several leading indicators had suggested that conditions were improving markedly. All divisions experienced a strong improvement in trading, on a like-for-like basis. Sales in General Merchanting rose 14.6%; the Contracts division was up 11.1%; the Consumer division was up 6.8% and the Plumbing and Heating division was up 7.4%. Net debt continued to decline and was £297m at the period end (2013: £406m).

Management said that certain parts of the business have become more susceptible to pricing pressure that has arisen due to the pricing transparency available on mobile devices. This has been partly exacerbated by the rise of the so called "fixed price merchant". Travis Perkins offers its customers bulk deals at the discretion of the branch manager; some customers have recently been demanding price matching. Management think that the threat is containable and limited and that the margin hit can be offset by clever buying although clearly this is an area to be watched closely.

Since the downturn in 2007/8, Travis Perkins has reduced capital expenditure. The number of new branch openings slowed and all but the most essential maintenance spend was curtailed. Consequently, parts of the business became underinvested and there is pent-up opportunity to open new branches. They have recently reversed this trend and capital expenditure is forecast to be £130m - £150m for the full year; they spent £65m in the period, 24% more than last year. We met management shortly after the results and were pleased to hear that John Carter and Tony Buffin have the same focus on return on capital as the previous management, who we rated very highly. So although we will see capital spending rise over the next few years, it will be done rationally.

An area of interest where we expect to see development is the Group's online capability. When we met management last year they had recently hired a high profile IT commerce professional from Tesco who intended to roll out a Group-wide online retail capability. However, more recently management have decided to spend time refining and preparing the supply chain so that they can launch a fully integrated "click and collect" offer. Online retail has been slow to develop in the building materials supply sector but offers a number of potentially interesting opportunities to the Company. Other areas of likely capital spend include branch format refreshes, new branches of Tool Station and Travis Perkins and improvements to service delivery.

CEO John Carter said that "*we have outperformed our markets and see good growth opportunities for stepping up our investment in the customer proposition, leveraging* *our superior scale, supply chain capabilities and for network expansion and format optimisation. These exciting organic growth opportunities along with a clear focus on return on capital should continue to create substantial shareholder value. Trading is consistent with our expectation and with lead indicators in our different markets encouraging, the Group is expected to show continued solid growth for the remainder of the year*."

The share price increased by 2% in the quarter.

Randall & Quilter – Current Weighting 3.5%

The Company reported in their Interim results. Total Group income was £35.1m with a loss before tax of £0.6m. The undiscounted net tangible asset value per share was 109.4p down from 116.4p. The performance of the three main divisions was mixed. The Insurance Investments division reported an improved operating result of £1.6m (2013: £0.8m) and generated higher investment income of 2%. There was a higher contribution from new legacy transactions and a worse result from insurance debt purchases and syndicate results. The Insurance Services Division reported a lower operating profit of £3.8m (2013 £6.3m) as the US was affected by lower credit write backs than experienced previously. The Underwriting Management Division reported an operating loss of £0.7m (2013 £0.1m profit) mostly due to a reduction in commission received.

Chairman and CEO Ken Randall said that "*whilst financial performance was weak in the first half, as flagged in the AGM trading update, 2014 has seen many positive developments. We have progressed a number of legacy insurance transactions in the first six months of the year, using our newly enhanced and flexible legacy platforms, and the newly refinanced bank facility provides additional long term investment capacity for our healthy ongoing pipeline*".

The share price fell by 8% in the quarter.

BWIN Party – Current Weighting 3.1%

In September, BWIN announced that their owned "in-house" payments provider, Kalixa, has formed a JV with Millicom, a large international telecommunications and media company. The purpose of the JV is to give Kalixa greater scale ahead of a possible realisation of value in the near to medium term.

In August BWIN reported in their Interim results that. Group revenue declined from €342.5m to €317.1m due to a number of factors that the Company has previously mentioned; the decision to shift the business from "volume to value", a weak international poker market and the closure of the Greek market. Also, the US market has proved weaker than expected since the launch in New Jersey. These factors were partly mitigated by good results in sports betting from the FIFA World Cup and the strong growth in mobile revenue, albeit from a low base. The Group generated clean EBITDA of €46.4m, down from €60.7m for the same period last year. Sales by product vertical compared to the result last year were as follows:

Product	**Revenue 2014 (€m)**	**Revenue 2013 (€m)**
Sports Betting	€89.1	€78.3
Casino & Games	€27.6	€25.8
Poker	€19.6	€26.3
Bingo	€26.0	€27.0
Other	€15.6	€19.8

In the press release and at our meeting with Management, they talked extensively about the self-help measures being employed to improve both the day-to-day operational performance of the business and the prospects for realising long-term value. The business has been reorganised according to brand rather than vertical; this change is intended to give employees a better sense of ownership of their role and also to make parts of the business more attractive to potential investment partners or, ultimately, acquirers. It is also speeding up decision making in the business.

Cost cutting also continues to be a focus with management looking to achieve a further €15m of savings in 2015 in addition to €30m already identified; management are also considering non-core asset disposals. Furthermore the Group is increasingly directing its efforts towards customers in markets that are nationally regulated; group revenue from nationally regulated markets was €178m, almost flat versus the same period a year ago and representing 56% of total revenue. In addition to having a lower regulatory risk profile, nationally regulated markets often have a much more favourable competitive dynamic because large pooled liquidity sites (such as Poker Stars) cannot operate in the same way in regulated markets (if at all.)

CEO Norbert Teufelberger said of current trading that, "*Trading since 30 June 2014 has been in-line with our expectations with average daily net revenue down 4% versus last year. Regulated and/or taxed markets were up 2% over the same period, driven by sports betting that was up 11% and casino that was up 7%.*"

The share price was down 4% in the quarter.

Vesuvius – Current Weighting 3.1%

The Company reported in a good set of Interim results Revenue of £730m, which although down 5.6% on a reported basis due to the negative impact of the strength of Sterling, was actually up 4.7% on an underlying basis. Indeed trading profit was £71.2m, up 0.7% on a reported basis, but up 14.3% on an underlying basis as they continue to implement operational and strategic initiatives across all their businesses.

They saw strong performance in their Steel division with revenue up 6% on an underlying basis (trading profit up 23%), outperforming the global steel market excluding China that was up 2.5%. Again this is the result of them increasing the penetration of their technologically advanced systems and the introduction of new product ranges especially in their 'Steel Flow Control' division which saw crude steel production up in Asia (particularly South Korea) and Europe, Middle East & Africa despite declining steel production in South America and sluggish growth in America (where supply chain was impacted by bad weather in the first half). Their Advanced Refractories division saw them benefitting from more 'higher value-added' solutions to customers and exiting lower margin businesses.

Their Foundry division saw underlying revenue up 2% in a market that continues to experience difficult trading, with no substantial improvement in the end-market conditions (represented mainly by the heavy and light vehicle industries). The ongoing weakness in commodity and precious metals prices in the mining sector is also impacting investment spending. Hence, Vesuvius continue to invest for the medium term with Phase 1 of their new Chinese manufacturing plant now complete; Phase 2 will complete by 2015. This will help them serve an increasingly sophisticated domestic market where more companies are adopting best practice in global manufacturing standards requiring more advanced technological solutions.

Management reported that the outlook for the second half to be similar to the first, and remain confident in its expectations for the full year.

Vesuvius also reported their first acquisitions since the demerger from Cookson for £30m to build their presence as a leading technical services provider: Ecil Met Tec has operations in Brazil and USA to manufacture and supply consumable thermocouples used to measure temperature of molten metal; Process Metrix based in the USA supplies laser units to measure refractory wear in vessels in the steel making process.

The share price was flat in the quarter.

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